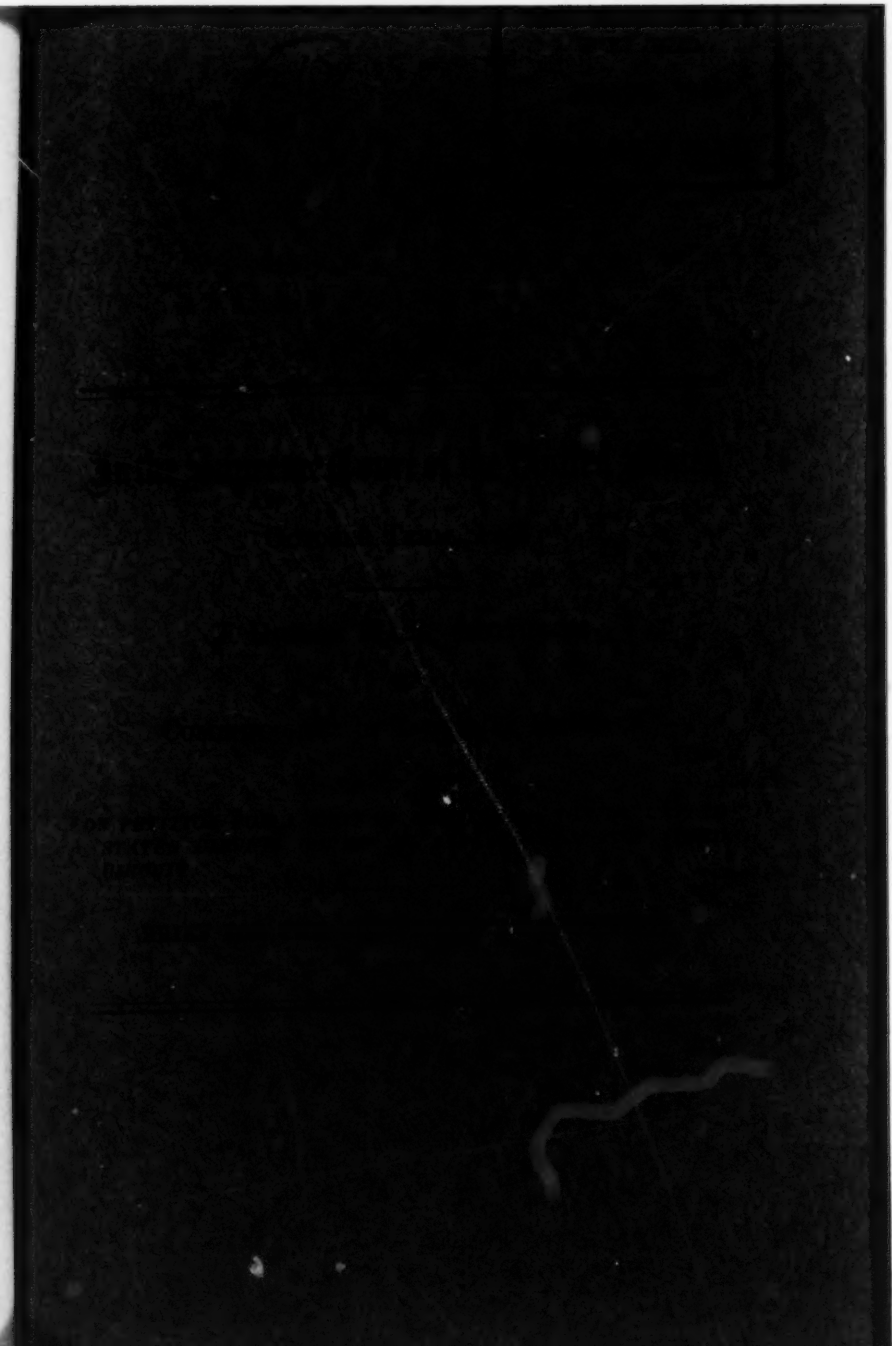

INDEX

CITATIONS

651628—45

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 97

J. GORDON MACK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinions of the Tax Court (R. 24–35) are reported in 3 T. C. 390. The opinion of the Circuit Court of Appeals (R. 40–42) is reported in 148 F. 2d. 62.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 1, 1945 (R. 42). The petition for a writ of certiorari was filed on May 28, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where taxpayer, in accordance with the provisions of the will of his deceased father establishing a testamentary trust, exercises an option to purchase from the trustees shares of common stock at a price equal to one-half the market value of the shares at the time of the exercise of the option, does his basis on a subsequent sale of the shares include an alleged value of the option in addition to the actual money paid the trustees for the shares?

STATUTE INVOLVED

The relevant provisions of the statute involved are set forth in the Appendix, *infra,* pp. 11–13.

STATEMENT

The facts were found by the Tax Court as stipulated by the parties (R. 14, 24). They are, in substance, as follows:

Taxpayer is a resident of McKeesport, Pennsylvania. On September 27, 1940, his father died testate leaving a will which was duly probated in the Orphans' Court of Allegheny County. (R. 14.) The eighth paragraph which establishes a testamentary trust for the benefit, *inter alia,* of taxpayer, his brother, and four named institutions, provides in part (R. 18, 19–20):

> *Eighth:* All the rest, residue and remainder of my estate, real, personal and mixed, whatsoever, and wheresoever situate, I give, devise and bequeath unto

Union Trust Company of Pittsburgh and J. Paul Fife, Esq., in trust, for the following uses, persons and purposes, and with the following powers:

* * * * *

(b) I direct that my Trustees shall set aside *Twenty Thousand (20,000)* shares of my common capital stock of G. C. Murphy Company for the benefit of my sons John Gordon Mack and James S. Mack and the institutions hereinafter mentioned. At any time during the first ten (10) years after the date of my death my Trustees shall sell and deliver to my said sons said Twenty Thousand (20,000) shares and any stock dividends thereon, or such part thereof as they shall from time to time elect to purchase, at one-half (½) the average market price per share as hereinafter defined, each son to be entitled in the aggregate to one-half (½) of said Twenty Thousand (20,000) shares and stock dividends, unless the other should fail or refuse to purchase his full one-half (½) of the total. For the purpose of this paragraph average market price per share during any calendar month shall be the mean between the high and the low of the market price of said stock during the six (6) calendar months immediately preceding the date of the particular purchase, and the price at which my sons shall be entitled to purchase said stock from time to time shall be one-half (½) said average market price. The net

proceeds of each such sale and the net cash dividends from said stock (or so much of the stock as shall not have been sold to my sons) after deduction of proper charges and expenses applicable thereto, shall be paid to the following, in the proportions indicated:

The Mack Foundation, created by me during my lifetime	45%
Endowment Fund, Westminster College, New Wilmington, Pa.	20%
Bob Jones College, Cleveland, Tennessee	20%
Southwestern Presbyterian Sanatorium, Albuquerque, New Mexico	15%

At the expiration of ten years from the date of my death, such part of said twenty thousand (20,000) shares of capital stock and stock dividends thereon as my said sons shall have failed or refused to purchase shall be sold to any purchaser or purchasers at the best price obtainable, as soon as conveniently may be and as soon as may be for the best interests of my estate, and the proceeds thereof shall be paid to the aforementioned institutions in the percentages indicated. My Trustees may, however, at their discretion, if so requested by my sons or either of them, extend beyond said ten year period the time within which said sons or either of them may purchase the shares of stock then remaining unsold, but such extension shall in no event exceed a period of two years and six months.

On November 25, 1940, taxpayer exercised the option specified in the will and acquired five shares of the stock at a monetary cost of $170.30, or $34.06 per share. The average market price

at the date of purchase, as defined in the will, was $67.625 per share; for September 27, 1940, the date of taxpayer's father's death, it was $69.50 per share. The fair market value of the shares on the latter date was $78 per share. (R. 14–15.)

On December 31, 1940, taxpayer sold the five shares for $346.12 or $69.224 per share (R. 15). In his income tax return for the calendar year 1940, taxpayer reported a short term capital loss on the transaction as follows (R. 15):

Cost or other basis	$360.30
Expenses of sale	3.26
Total	363.56
Gross sales price	349.38
Loss to be taken into account	14.18

The Commissioner disallowed the loss and determined a deficiency of $20.90 by changing the basis of the shares from $360.30 to $170.30, the actual money paid the trustees for the shares (R. 8, 15–16).

The Tax Court sustained the Commissioner's determination (R. 35a) and the Circuit Court of Appeals affirmed the decision of the Tax Court on the authority of *Helvering* v. *San Joaquin Co.*, 297 U. S. 496, rehearing denied, 297 U. S. 728 (R. 40–42).

ARGUMENT

1. Taxpayer cannot successfully, and apparently does not, argue that the basis of the shares is anything but cost. Obviously, the shares them-

selves were not acquired by bequest. For purposes of the Revenue Acts, it is beyond argument that the shares were acquired by purchase at the time of the exercise of the power given taxpayer in his father's will without regard to any doctrine of "relation back." *Helvering* v. *San Joaquin Co.*, 297 U. S. 496, rehearing denied, 297 U. S. 728; *Palmer* v. *Commissioner*, 302 U. S. 63, 71. However, it is taxpayer's contention that he gave an option as well as cash for the shares. But he gave no option to the trustees in exchange for the shares. The amount the trustees realized within the meaning of Section 111 of the Internal Revenue Code (Appendix, *infra*, p. 11) was only the actual money received. For although the option may have been a valuable property right, by the very terms of the bequest it was personal to taxpayer and his brother and could not be transferred or assigned. The Tax Court so treated it and taxpayer does not challenge this. (Br. 30.) All taxpayer did was to exercise the power to purchase the shares given him by his father's will. His out-of-pocket cost of the shares was the amount of cash actually paid and nothing more. The option was not property exchanged, was not transferred to the trustees, and can form no part of the cost basis of the shares purchased.

As the Tax Court and the Circuit Court of Appeals held, this question has been expressly settled by this Court in *Helvering* v. *San Joaquin Co.*,

supra, which decision has subsequently been approved in *Palmer* v. *Commissioner, supra* and *Commissioner* v. *Smith,* No. 371, October Term, 1944, decided February 26, 1945, rehearing denied April 9, 1945. In the *San Joaquin* case real estate was leased for a term of ten years from December 1, 1906, with an irrevocable option in the lessee to buy the whole acreage for $200,000, exercisable November 30, 1916. By March 1, 1913, the value of the property had greatly increased. On November 30, 1916, the option was closed and conveyance made to the lessee, which subsequently transferred the land to the Fruit & Investment Company under circumstances which did not alter the basis for calculation of gain. During 1920 to 1928, the Fruit & Investment Company sold portions of the tract and contended that the exercise of the option on November 30, 1916, with the payment of $200,000 for the conveyance of the land, constituted merely an exchange of capital assets—the very argument advanced here—and that the basis for the land (including improvements) was its value at that date, more than the actual money expended. But this Court rejected the contention, saying (p. 500):

> The capital asset, sale of which resulted in taxable gain, was the land. This was not an asset of the taxpayer prior to the exercise of the option. We think it clear that there was no combination of two capi-

> tal assets—the option and $200,000 of cash, to form a new capital asset, the land, which was subsequently sold at a profit. * * *

Consequently, this Court upheld the Commissioner's determination that the basis for the land was $200,000 plus the amounts expended by the taxpayer for improvements.

Taxpayer's attempt to distinguish the *San Joaquin* case (Br. 17) on the ground that the option there may have had a fluctuating or no value, whereas here its value was constant at one-half of the market price of the shares, does not bear scrutiny. It should be noted that in the *San Joaquin* case, both the March 1, 1913, and November 30, 1916, values of the land were greatly in excess of the $200,000 option price. Under the rationale of *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, the March 1, 1913, value of the option bore the same relationship to the problem there as does the value of the option at the date of the father's death to this case. Accordingly, there was a comparable spread between market and option prices in both instances. Nevertheless the option, which admittedly also had value at the time of its exercise, was not treated as part of the cost of the land.

2. Conflict is alleged with *Robinson* v. *Commissioner*, 59 F. 2d 1008 (C. C. A. 6th); *Hawke* v. *Commissioner*, 109 F. 2d 946 (C. C. A. 9th); *Connolly's Estate* v. *Commissioner*, 135 F. 2d 64

(C. C. A. 6th); and *Commissioner* v. *Smith, supra.* However, none of the cases referred to deals in any way with the problem of increasing the basis of shares of stock purchased by the value of an option acquired by bequest. The *Connolly, Hawke* and *Smith* cases present the question of whether the spread between option and market price at the time of the exercise of the option may be included in income as compensation for personal services. While in those situations the amount of such compensation reported as gross income may be added to the basis of stock acquired, this is specifically provided for by the Treasury Regulations[1] and there is no comparable regulation applicable here. In those cases, the transferors received services from the transferees; here the trustees received only cash. To the extent that the opinion in the *Robinson* case speaks of a gift of stock to the employee and allows the value of the gift to be added to the basis of the stock when sold, its reasoning has been supplanted by the *San Joaquin* case. It should be noted, moreover, that the treatment of the transaction in the *Robinson* case as a gift was only an alternative ground of decision, and that the case has been subsequently classified with the compensation cases. See *Commissioner* v. *Merrell,* 93 F. 2d 466, 468 (C. C. A. 2d).

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[1] See for example Treasury Regulations 111, promulgated under the Internal Revenue Code, Section 29.22 (a)–1.

CONCLUSION

The decision below is correct since it specifically follows the judgment announced by this Court in the *San Joaquin* case. There is no conflict which requires resolution and no occasion for further review. The petition should therefore be denied.

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JUNE 1945.